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IMPROVING FISCAL MANAGEMENT IN GHANA: THE ROLE OF FISCAL POLICY RULES

by
Dr. Charles Amo-Yartey*

Summary

This paper discusses the role of fiscal policy rules in promoting fiscal discipline and transparency in Ghana. It investigates whether the adoption of fiscal policy rules and independent fiscal policy councils can help improve fiscal performance in Ghana based on international evidence. The results show that fiscal rules, particularly budget balance and debt rules are strongly associated with a higher probability of reducing the public debt to GDP ratio. The paper then calibrates an illustrative simple fiscal rule for Ghana based on the debt sustainability approach with a debt to GDP target of 50 percent of GDP by 2020. Achieving this target requires average fiscal deficits of about 4 percent of GDP. The paper argues that fiscal rules do not operate in isolation and require supporting institutions and reforms to deliver the anticipated outcome. Key reforms to make fiscal rules effective in Ghana include strengthening budget preparation, apportionment and execution; establishing an independent fiscal policy council to provide independent assessment of macroeconomic and revenue forecasts; monitoring and enforcement procedures, and legislative changes to make the fiscal rule legally binding.

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The Editor, The Institute of Economic Affairs, P. O. Box OS 1936, Accra.
Tel: +233-302 244716 / 226333 / 226359 / 226388, 030 7010713/4.
Fax: +233-302 222313. Email: iea@ieagh.org, Website: www.ieagh.org

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Perhaps, the single most important factor that could derail Ghana's ability to advance to high middle income status is weak fiscal governance. Fiscal management in Ghana has not been consistently strong. Poor revenue collection, built upon an inadequate tax base and low tax compliance, has combined with expenditure pressures particularly in election years leading to large and continuous public sector borrowing. Historically, this unsatisfactory fiscal governance has been at the centre of a vicious cycle in which the public sector's appetite for debt financing has contributed to high interest rates; put pressure on the exchange rate as economic agents are unsure about the sustainability of public debt; raised and distorted the cost of capital; and crowded out private sector investments.

Breaking the cycle of inconsistent fiscal management clearly requires a balance between market pressure and fiscal rules in order to keep public finances on a sustainable path. Empirical evidence shows that the quality of market signals is by itself an insufficient indicator to accurately guide the conduct of fiscal policy especially in periods of crisis. This calls for a further quantum improvement in fiscal governance, which embeds a credible improvement in fiscal responsibility and permanently eliminates fiscal deficits, except for well-defined special circumstances. Fiscal consolidation in Ghana needs to be credible in order to anchor market expectations about fiscal sustainability.

This paper discusses the role of fiscal policy rules in promoting fiscal discipline and transparency in Ghana. It investigates whether the adoption of fiscal policy rules and independent fiscal policy councils can help improve fiscal performance in Ghana based on international evidence.

Weak fiscal governance threatens macroeconomic stability

Ghana has a track record of high fiscal deficits, partly reflecting procyclical fiscal policies in good times and electoral cycles. A review of fiscal performance in Ghana over the past two decades shows that the country has not been able to keep the government budget under control and fiscal consolidation has not been successful. For instance, the average fiscal deficit for Ghana between 2005 and 2013 was 7½ percent of GDP compared with just 3 percent of GDP for sub-Saharan Africa. Fiscal performance in Ghana tends to worsen during election years with concomitant increase in the debt levels.

Over the years, revenue performance has improved significantly while at the same time primary spending has strongly increased. Between 1990 and 2013, total revenue as a share of GDP increased from 9 percent of GDP to around 18 percent of GDP though still below the average for middle income countries. At the same time, primary spending has consistently been higher than revenues with spending particularly higher during election periods. For instance, both the 1992 and 1996 elections resulted in higher fiscal deficits in the 1990s and the same pattern was observed in the period between 2000 and 2012. Government, concerned about securing the support of public service labor unions, granted substantial wage increases in election years and embarked on ambitious capital projects many of them unproductive.

Wages and salaries is now the biggest component of government spending. It accounts for an average 9 percent of GDP and its share of GDP has grown significantly over the past three years. Public wage growth outstripped real GDP growth over the past ten (10) years. Analyzing the real growth of expenditures on public wages and salaries together with real GDP growth shows that overall the growth of real expenditure on public wages has been higher than real GDP growth during the past 10 years. On the positive side, in periods of low GDP growth, wage growth has been particularly low. Additionally, in periods immediately after wage hikes, wage growth decelerated. For example, in 2005 and 2009, public wage growth fell significantly and was below the growth rate of real GDP.

Addressing Ghana's macroeconomic challenges requires an ambitious fiscal consolidation strategy. The fiscal deficit is currently very high and Public debt is rising even though it is still within the range considered sustainable. It is important to note, however, that the debt trajectory is as important as the debt level in terms of influencing investor confidence and economic growth. A huge debt build up tends to undermine investor confidence and could limit growth even in situations where debt levels are low.

International experience suggests that the initial level of fiscal adjustment is important for the success of fiscal consolidation. The question is, "What is the most appropriate route to follow given that the need to reduce the budget deficit comes in a difficult environment of weak growth and difficult political environment?" Based on a survey of country experiences, expenditure-based consolidations with a focus on reducing current spending tend to be more successful than tax-based consolidations. However, since the adjustment need in Ghana is large, fiscal consolidation needs to be a balanced combination of spending cuts and revenue increases. Fiscal adjustment needs to be completed with a rule-based fiscal policy to lock in the gains of fiscal consolidation and enhance policy credibility.

Countries find fiscal rules useful for instilling fiscal discipline and for undertaking large adjustments.

Several governments across the world have adopted fiscal policy rules, especially against the backdrop of worsening fiscal performances and rising debt levels. Empirical evidence indicates that fiscal rules have positive and statistically significant impact on budget balances and the relationship is robust to the possibility of omitted variables and to the definition of the government balance. Reforms of fiscal institutions and the introduction of fiscal rules are motivated by the objective, similar to those in monetary policy, that rule-based policies are likely to deliver better results. The objective of adopting a fiscal rule is to strengthen fiscal solvency and sustainability, contributing to macroeconomic stabilization, and making fiscal policy design and execution more resilient to government corruption and private sector lobbies.

Fiscal policy rules could be defined as a permanent constraint on fiscal policy through simple numerical limits on budgetary aggregates. This definition implies that boundaries are set for fiscal policy, which is difficult to change frequently and some operational guidance is provided by specifying a numerical target that limits a particular budgetary target.

Fiscal rules are normally aimed at correcting distorted incentives and containing pressures to overspend, particularly in good times, so as to ensure fiscal responsibility and debt sustainability. The literature has put forward two reasons to account for the resulting deficit biasgovernment's shortsightedness and the common pool problem since special interest groups do not internalize the overall budgetary impact of their competing demands. In many countries, the existence of many competing interest groups usually results in the “voracity effect”, where different groups compete and push for overspending especially in good times leaving little or no room for counter cyclical policies in bad times. To solve these problems, a number of fiscal institutions including fiscal rules and medium term budget frameworks have been established around the world over the past three decades with a view to supporting more prudent and balanced fiscal policies.

Another justification for the implementation of numerical fiscal rules is to prevent policy makers from worsening macroeconomic volatility through procyclical fiscal policies. More specifically, there is a widespread consensus on the impact of fiscal rules that restrict government expenditure. According to the European Commission, enforced national expenditure rules help to counteract forces leading to pro-cyclical fiscal policy in good times and thus prevent the need for fiscal austerity measures in difficult times.

Fiscal policy rules are statistically associated with better fiscal performance

To examine the impact of fiscal policy rules on fiscal performance the paper uses a dataset spanning over three decades for a large sample of developed and developing economies using the conditional logit regression approach. The analysis uses a panel data of 160 countries for eight, five year periods to estimate the probability that a large debt reduction would be initiated in each five year period. The dependent variable is the probability of a large debt reduction. The variable takes the value of 1 if a large debt reduction occurs and 0 otherwise. We define a large debt reduction as occurring when the debt to GDP ratio declines by at least 15 percentage points over a 5 year period. The explanatory variables are measures of fiscal rules, macroeconomic variables, political and institutional variables, and fiscal consolidation. Fiscal rules is a dummy variable, which takes the value 1 for the presence of fiscal rules in country and time, and 0 otherwise.

Simple comparative statistics show that countries that experienced a large debt reduction were more likely to have fiscal rules and were on average able to achieve a higher GDP growth and larger primary surpluses than countries that did not experience a large debt reduction.

The main result from the empirical analysis is that global large debt reduction are positively associated with the existence of fiscal rules, strong economic growth, favorable external environment, lasting fiscal consolidation, and weak initial conditions. Fiscal rules tend to increase the probability of a large debt reduction because they help strengthen the fiscal framework and improve fiscal transparency. Which types of fiscal rules are more successful in debt reduction? The results show that debt and budget balance rules are important in explaining the probability of a large debt reduction. Revenue - and expenditure - based fiscal rules do not appear to have any significant impact on the probability of a large debt reduction. The results are robust to different estimation techniques, alternative definition of large debt reduction, and exclusion of oil exporting countries.

The adoption of debt and budget balance rules in Ghana will enhance fiscal credibility

A cursory look at Ghana's fiscal framework suggests existing fiscal rules are insufficient to improve fiscal discipline. There is therefore the need to implement a fiscal rule that has broad coverage of the budget more generally and further reduce discretionary policy interpretations. The paper then calibrates an illustrative simple fiscal rule for Ghana based on the Debt Sustainability Framework (DSF) with a debt to GDP target of 50 percent of GDP by 2020.

The DSF determines a floor on the path of overall balances that could achieve the debt ceiling by a given target date. In this way, the DSF approach provides a direct link between the long-term public debt target and the annual overall balance target. A credible target should be realistic while also sufficiently ambitious to restore sustainability and credibility with budget stakeholders. A debt ceiling in the range of 50 percent of GDP could represent an appropriate balance because it is consistent with the view of the government of a sustainable debt level and also below the threshold of 60 percent of GDP associated with an elevated chance of debt distress in emerging markets.

The paper calibrates an illustrative fiscal rule with the objective of achieving a debt target of 50 percent of GDP by 2020. The main difference between the baseline and the fiscal rule illustration is the extent of frontloading in the required adjustment, which has implications for the medium-term fiscal balance. The baseline scenario assumes unchanged policies while the debt rule scenario assumes a frontloading of fiscal adjustment. Under the baseline, the overall balance targets for 2014-2020 are set in line with the government objective of a gradual fiscal consolidation**.** This framework does not achieve the target and only reduces the debt to GDP ratio by about 7 percentage points by 2020. The goal of the debt rule scenario is to frontload the fiscal adjustment to allow for a higher overall balance beginning in 2015. Under this scenario, the debt target would be achieved in 2020 requiring an average fiscal balance of 4 percent of GDP. The debt rule scenario achieves the desired debt target while enhancing fiscal credibility because of the more rapid debt consolidation compared to the baseline. However, it requires greater fiscal adjustment in the near term than currently envisaged in the baseline scenario, which may be challenging.

Fiscal rules require supporting institutions and reforms

Fiscal rules tend to be most effective when they incorporate the entire public sector and are enacted by law or incorporated in the constitution. Effective fiscal rules are also expected to include well defined sanctions if the rules are broken and clearly defined correction mechanisms. International experiences suggest that fiscal rules do not function in isolation and require supporting institutions and reforms to deliver the anticipated outcome. Key reforms to make fiscal rules effective in Ghana include the establishment of an independent fiscal policy council; strengthening budget preparation, apportionment and execution; enhancing revenue forecasts; improving monitoring and enforcement procedures; and legislative changes to make the fiscal rule legally binding.

Strengthening the precision of revenue forecasts and the sanctions regime are important to establish a credible fiscal rule. Projections of available resources in the next fiscal year are needed earlier in the budget preparation process to determine realistic expenditure ceilings. An automatic correction mechanism can control for ex- post deviations from the fiscal rules. Strengthening enforcement procedures, such as sanctions for breaches of budgetary procedures and expenditure controls, will also be needed to encourage ex-ante compliance with the rules. Strengthening the sanctions regime will need to be addressed in legislation.

An independent fiscal policy council would enhance the quality of budget discussions and foster greater transparency. Independent fiscal policy councils can play the same role as monetary policy committees, deciding on deficits and the evolution of public debt. In Ghana, an independent fiscal council could have a key role in assessing the reliability of the macroeconomic and revenue assumptions underpinning the budget, and estimating the fiscal impact of proposed measures. In some countries, fiscal councils also play a "watchdog" role by monitoring compliance with fiscal rules. In addition, forecasts produced by fiscal councils can serve as a neutral baseline to assess the fiscal cost and macroeconomic impact of policy proposals. The mandate of fiscal councils in a few countries even allows for direct influence over the budget by specifying technical inputs, such as the macroeconomic and budgetary forecasts. To be effective, fiscal policy councils need to be given a clear mandate, debt sustainability, so that they are freed from the time inconsistency problem that leads to a deficit bias.

In addition to fiscal rules, strengthening fiscal performance in Ghana will require gaining control over the wage bill. Efforts should be devoted to ensuring a clean payroll system in the country. In addition, the wage setting process needs to be reviewed with a possible shift towards multi-year agreements that would be negotiated before the budget is finalized. Collaboration with labor unions would be critical in this regard.

The incorporation of these recommendations into Ghana's present fiscal framework will help in the achievement of fiscal targets and aid in the correction of fiscal loopholes that have proven so costly to the performance of the broader economy.

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*Dr. Charles Amo-Yartey is the Resident Representative of the International Monetary Fund (IMF) in Liberia. He holds a Ph.D in economics from the University of Cambridge, which he attended as a Gates Scholar. He is the co-editor of the book Caribbean Renewal: Tackling Fiscal and Debt Challenges and the author of the book Stock Market Development in Africa. He has worked in several departments of the IMF including African, Western Hemisphere, and Research. The conclusions of this paper are those of the author and should not be assumed to represent the views of the International Monetary Fund or taken as IMF policy.